

FORMULA APPORTIONMENT OF CORPORATE INCOME FOR STATE TAX PURPOSES: NATURA NON FACIT SALTUM

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Conflict and friction in taxation appear to be inherent characteristics of a federal system. This Symposium attests the fact that the fiscal problems of federalism are significant and continuing. Currently, this congeries of difficulties assumes additional importance because of the heavy strain placed on both federal and state tax systems by existing expenditure requirements. Since there is little in the present situation that suggests any material short run reduction in the demand for public services, continued study of perennial state tax problems is appropriate.

One such problem derives from the varying impact of Commerce Clause interpretation on the permissible scope and form of state taxation of corporations carrying on a multistate business. It is obviously difficult to achieve an appropriate balance between the national interest in the free flow of commerce and the state interest in obtaining adequate revenues. This subject has been given consideration in other articles in this issue of the *Journal*¹ and elsewhere.² This article deals with the narrower but related topic of determination of the amount of income subject to state taxes on or measured by net income as applied to corporations engaged in a multistate business. Accordingly, no attempt is here made to generalize the problem of state taxation of interstate commerce which is most difficult to consider on other than a case by case basis.³

APPORTIONMENT PROBLEM IDENTIFIED

At present some thirty-three states levy corporate taxes on or measured by net income. This tax pattern raises the question of what portion of the income of a corporation doing a multistate business is subject to taxation in a particular levying state. The general rule appears to be that, assuming jurisdiction, a state may tax all of the income of a domestic corporation and that portion of the income of a foreign corporation reasonably and appropriately attributable to the taxing jurisdiction. A non-discriminatory, fairly apportioned tax levied *directly* on net income has been upheld even though part of the income taxed was derived from

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¹ Braden, *Cutting the Gordian Knot of Interstate Taxation*, 17 Ohio St. L.J. 61.

² See e.g. HARTMAN, *STATE TAXATION OF INTERSTATE COMMERCE* (1953); Drazen, *Recent Trends in State Taxation of Interstate Commerce*, 34 TAXES 286 (1956); Hartman, *Sales Taxation in Interstate Commerce*, 7 VAND. L. REV. 138 (1956); Hellerstein, *State Franchise Taxation of Interstate Business*, 4 TAX L. REV. 95 (1948); *State Taxation and Interstate Commerce*, 54 COL. L. REV. 261 (1954).

³ See Frankfurter, J. in *Freeman v. Hewitt*, 329 U.S. 249, 252 (1946).

interstate commerce.⁴ On the other hand, it appears that reasonable apportionment will not validate a privilege tax measured by net income when applied to a foreign corporation exclusively engaged in interstate commerce.⁵ For a time it appeared that the Supreme Court might validate a non-discriminatory privilege tax measured by net income from interstate transactions derived from within the taxing state.⁶ This no longer appears to be the wave of the future; however, there is much to be said, particularly from an economic point of view, for the more liberal notion of taxability that only a few years ago appeared to be in process of development.⁷

Despite changes in fashions in judicial opinion and changes in the interpretation of the thrust of the Commerce Clause, formula apportionment of income for state tax purposes remains a necessary part of the apparatus of state taxation of corporations carrying on a multi-state business. Three techniques ordinarily are used in determining what portion of the income of such a corporate taxpayer may be attributed to a particular state for tax purposes. These are: (1) specific allocation of particular categories of income, (2) formula apportionment of income, and (3) separate accounting.⁸ A number of jurisdictions require that particular classes of income be allocated on various bases including property situs, residence, and domicile. The remaining income not subject to allocation is apportioned under the terms of a statutory formula. Separate accounting is permitted in two different sets of circumstances: (1) where the so-called "non-unitary" character of the business permits an effective separation of receipts attributable to a given jurisdiction to be made; and (2) where, despite the fact that the taxpayer's business is a unitary operation, separate accounting is an allowable alternative to the application of a statutory apportionment formula. This article will be primarily concerned with statutory apportionment formulae; only minor and incidental consideration will be given to allocation of classes of income and to separate accounting.

⁴ *U.S. Glue Co. v. Oak Creek*, 247 U.S. 321 (1918); *West Publishing Co. v. McColgan*, 27 Cal. 2d 705, 166 Pac. 2d 861, aff'd 328 U.S. 823 (1946).

⁵ *Alpha Portland Cement Co. v. Commonwealth*, 268 U.S. 203, 477 (1925); *Spector Motor Service Inc. v. O'Connor*, 340 U.S. 602 (1951) reversing 181 Fed. 2d 150.

⁶ *Memphis Nat'l Gas Co. v. Beeler*, 315 U.S. 649, 656 (1942).

⁷ See, Rutledge, J. concurring in *General Trading Co. v. State Tax Comm.* 322 U.S. 335 at 358 (1944); see also, *Interstate Oil Pipe Line Co. v. Stone*, 337 U.S. 662 (1949).

⁸ Despite the lack of uniformity in the use of the words "allocation" and "apportionment" (as much as the lack of uniformity in the formulae sought to be described), specific distinction will be made here. "Allocation" will be used to refer to the assignment of specific items or categories of income to a given taxing jurisdiction. "Apportionment" will be used to refer to the determination of the amount of income attributable to a particular jurisdiction by means of the use of a formula.

It may be noted that this income apportionment problem is of no immediate concern in terms of the tax system of the State of Ohio. Ohio does not levy a state corporate income tax or a corporate franchise tax with an income measure of liability. Moreover, controversy about the present formula⁹ in the Ohio corporate franchise tax law has been largely laid to rest by the decision in *International Harvester Co. v. Evatt*.¹⁰ The apportionment problem does arise with respect to the application of Ohio municipal income taxes to corporate earnings.¹¹ Controversy about diversity in municipal tax policy has given rise to proposals for state legislative regulation of the scope of permissible municipal action with respect to the apportionment of income for city income tax purposes.¹² In this respect, the Ohio fiscal scene recapitulates at the municipal level the apportionment problems of the thirty-three income tax levying states.

Moreover, many Ohio corporations carry on a multistate business. Incident to operations in other states, they become subject to either state corporate income taxes or franchise taxes with an income measure of tax liability. Accordingly, the apportionment problem is appropriate not only in terms of the Symposium topic but also in relation to practical problems facing the legal representatives of such corporations.

BACKGROUND CONSIDERATIONS

Apportionment of income for tax purposes has been a matter of concern to many persons for a considerable period of time. An extensive literature on the subject has developed¹³ and numerous proposals for corrective policy change have been made. Such proposals have included, among other suggestions, three principal approaches to the problem. These are: (1) state withdrawal from the corporate income tax field¹⁴ or federal collection of state levied corporate income tax supplements to the federal corporate income tax; (2) Congressional action regulating state

⁹ OHIO REV. CODE §5733.05.

¹⁰ 329 U.S. 416 (1947) affirming 146 Ohio St. 58.

¹¹ See e.g. Brabson, *Municipal Income and Excise Taxes—Problems in Situs and Allocation*, 31 TAXES 143-148 (Feb., 1953); Lynn, *Local Income Taxation in the United States With Special Reference to the State of Ohio*, 11 J. of Fin. 80 (Mar., 1956).

¹² See Report of Taxation Committee, 29 Ohio Bar 347-352 (April 30, 1956).

¹³ See e.g. CONTROLLERSHIP FOUNDATION: APPORTIONMENT AND ALLOCATION FORMULAE AND FACTORS USED BY STATES IN LEVYING TAXES BASED ON OR MEASURED BY NET INCOME OF MANUFACTURING, DISTRIBUTIVE AND EXTRACTIVE CORPORATIONS (1954); ALTMAN & KEESLING, ALLOCATION OF INCOME IN STATE TAXATION (1950); FORD, THE ALLOCATION OF CORPORATE INCOME FOR THE PURPOSE OF STATE TAXATION (1933); also in the periodical literature see e.g. Houston, *Allocation of Corporate Net Income for Purposes of Taxation*, 26 ILL. L. REV. 725 (1933); Silverstein, *Problems of Apportionment in Taxation of Multistate Business*, 4 TAX L. REV. 207 (1949); Cohen, *State Tax Allocations and Formulas Which Affect Management's Operating Decisions*, 1 J. TAXATION 2 (1954).

¹⁴ This has been the developmental pattern in the Dominion of Canada. See e.g. DUE, GOVERNMENT FINANCE, 202, 256 (1954).

taxation of interstate commerce including legislative requirement for uniformity in apportionment methods,¹⁵ and (3) attempts at achieving cooperation among the several States in the development of uniform legislation on allocation and apportionment of income for state tax purposes.¹⁶ It is difficult to predict the line of long run development with respect to this problem area. It is also quite easy to express cynicism about prospects for action based on cooperation among the states. Be that as it may, there seems no immediate likelihood, at least to this writer, that policy will take either the first or second of the above indicated potential courses of action. Accordingly, the third approach—the development of formula uniformity through state action—will be here considered.

There is general agreement that existing methods for apportioning income for purposes of state taxes based on or measured by corporate net income are exceedingly diverse.¹⁷ For many years numerous persons and organizations have pointed out the desirability of uniformity in allocation rules and apportionment formulae. This objective is sometimes justified on the ground that, in terms of basic tax fairness, not more than one hundred percent of the income of a corporate taxpayer should be subject to the combined tax attentions of the several states.¹⁸ Equally, if not more important, is the fact that diversity in existing rules and practices increases both tax administrative and taxpayer compliance costs.¹⁹ While some have suggested that this point should not be overemphasized,²⁰ it is certainly desirable that compliance costs be minimized when possible. Such costs, if not clearly justified by revenue-raising necessity, are an undesirable social waste.

Granting the general desirability of uniformity, realism requires that note be taken of the lack of progress toward real uniformity despite the substantial amount of attention that has been accorded the problem over the years. It seems unlikely that scientific precision will ever be attained in this area. A number of years ago, a Committee of the National Tax Association observed:²¹

All methods of apportionment of trading profits are arbitrary

¹⁵See e.g. ALTMAN and KEESLING, *op. cit. supra* n. 13, Ch. XII.

¹⁶For a summary of alternatives see Kitendaugh, *Possibilities for Interstate Cooperation in the Area of Allocation Formulas*, in FEDERAL-STATE-LOCAL TAX CORRELATION (Princeton: Tax Institute, 1954) 205, 209.

¹⁷See e.g. note 13 *supra*.

¹⁸See e.g. Long, *Interstate Reciprocity in Connection With Corporate and Personal Income Taxation* in TAX RELATIONS AMONG GOVERNMENTAL UNITS (New York: Tax Policy League, 1938) 72, 77.

¹⁹The 1954 Controllershship Foundation study, cited n. 13 *supra*., estimated that under a uniform formula, regardless of what it might be, a saving of approximately 33% in existing compliance costs would be made.

²⁰Blough, *Fiscal Aspects of Federalism* in FEDERALISM MATURE AND EMERGENT, 1955, 384, 392.

²¹Report of the Committee on the Apportionment Between States of Taxes on Mercantile and Manufacturing Business, PROC. NAT'L TAX ASS'N, 1922, 201, 202, also quoted in Schultz & Harriss, *AMERICAN PUBLIC FINANCE*, (6th ed.) 1954, 328.

—the cutting of the Gordian knot . . . there is no one right rule of apportionment, notwithstanding that there are probably a number of different rules, all of which may work substantial justice . . . the only right rule of procedure is a rule on which the several states can and will get together as a matter of comity. Getting together by the uniform adoption of some equitable method and finding the right rule are synonymous.

The difficulty of finding an equitable rule of apportionment that generally can be agreed upon is apparent. The National Tax Association, as well as other similar groups, has continued the quest. The story of the evolving attitudes of that Association need not be recapitulated here; it is writ large over the pages of the annual Proceedings from 1916 to 1956.²² Moreover, much of the record of the Association has been well reviewed elsewhere.²³

While all states levying a tax on or measured by net income have adopted some kind of a formula and while many have adopted variations of the commonly suggested three factor formula based on property, payroll, and sales ratios, actual uniformity is more apparent than real. This is understandable in that basic conflicts of economic interest are present between states which are manufacturing areas and states which are predominantly markets for manufactured goods. Under such circumstances, agreement on a common formula is extremely difficult to attain. If, over the years, industry continues to become less geographically concentrated, agreement may become more of a real possibility.²⁴ The balance of this article will consider two recent developments in this field: (1) the studies of the Council of State Governments on the fiscal impact of alternative apportionment formulae, and (2) the tentative draft of a Uniform Allocation and Apportionment of Income Act under consideration by a special committee of the National Conference of Commissioners on Uniform State Laws.

THE COUNCIL OF STATE GOVERNMENTS STUDY

The 1953 Governors' Conference adopted a resolution on the existing apportionment of income problem which fairly summarizes the existing situation. It reads as follows:

Many states impose an annual franchise or other tax the net income of corporations.

In order to develop an equitable proportion of net income assignable to the states in which such corporations are doing business, certain statutory formulae are used.

²² A Committee on Interstate Allocation of Business Income reported at the 1956 annual meeting of the National Tax Association in Los Angeles. This report was not available at the time of this writing.

²³ See Kassell, *Progress Toward Achieving Uniformity in State Income Tax Administration* in *INCOME TAX ADMINISTRATION* (Princeton: Tax Institute, 1948) 292, 294-296.

²⁴ See in this connection Conlon, *Coordination of Federal, State and Local Taxation*, 266 *THE ANNALS* 144, 149 (1949).

These statutory formulae are not uniform and are not uniformly interpreted by the state tax departments, thus resulting in certain inequities and greatly increased cost of compliance with the state tax laws by corporations.

Accordingly, the Governors' Conference requests the Council of State Governments to study this problem with a view of attaining uniformity of statutory provisions relative to the apportionment of net income among the various states that would promote equity and decrease the cost of taxpayer compliance, and to report back to the Governors' Conference as soon as possible.²⁵

Meantime, the Controllershship Foundation, Inc., the research arm of the Controllars Institute of America, Inc. made an extensive study of this problem. Its report was published in 1954²⁶ and, while it made no specific recommendations, provided an excellent analysis of the existing situation. The situation as found by the Controllershship Foundation study and by the Council of State Governments may be summarized briefly.

As already indicated, two steps are ordinarily necessary in the application of state income-based taxes to corporations doing a multistate business. First, certain items of income and expense are treated separately. Non-business income such as interest, dividends, rents and royalties is allocated to a particular taxing jurisdiction. Second, the unallocated income is apportioned to a particular taxing state under the provisions of a statutory formula. Separate accounting, where applicable and authorized, may serve as an alternative method of determining the income taxable by the levying jurisdiction.

Most apportionment formulae presently in use include three factors. These are most commonly sales, payrolls, and property. Ratios are determined indicating the relation between that portion of each factor attributable to the taxing state and the total value of that factor. Such ratios are averaged and the resultant percentage is applied to total income to determine the portion of such income properly attributable to the taxing state. The basic theory of this process is that the factors selected will adequately reflect and measure the income creating activities of the corporation in a particular taxing jurisdiction. To the extent that this theoretical supposition is true, the resultant percentage of total unallocated income may be considered an appropriately determined tax base. While the basic theory of the apportionment formula is rough and ready in character, the use of this method provides a workable solution to the problem. Existing dissatisfaction arises not so much as a result of deficiencies in the theory of apportionment but rather is due to non-uniformities in application. Variations exist between the states in terms of: (1) alloca-

²⁵ COUNCIL OF STATE GOVERNMENTS: RECOMMENDATIONS FOR UNIFORMITY OF STATE INCOME TAXES ON CORPORATIONS DOING BUSINESS IN SEVERAL STATES (1954). Quotation from this and other Council of State Governments publications is made with the permission of that organization.

²⁶ *op. cit. supra*, n. 13.

tion rules for items of non-business income; (2) the factors included in statutory apportionment formulae; and (3) in the definition and application of superficially identical formula factors. As a result, considerable diversity exists. Certain income may be subject to multiple taxation; other income items may avoid taxation.

The Council of State Governments has summarized the existing apportionment formula situation as follows:²⁷

There is some degree of uniformity among the states with regard to the formulae used for apportionment. Almost two-thirds of the jurisdictions levying these taxes use a three-factor formula, and about one-half of them employ a formula made up of sales, payrolls and property. The following table indicates the formulae now in use and the frequency of their use:

Three Factors—Sales (gross receipts), payrolls, property	—14 states
Three Factors—Sales (gross receipts), costs, property	— 5 states
Three Factors—Sales, payrolls, average inventory	— 1 state
Two Factors —Sales (gross receipts), property	— 2 states
Two Factors —Cost of manufacturing, property	— 1 state
Two Factors —Business, property	— 1 state
One Factor —Sales (gross receipts)	— 3 states
Combinations of the above	— 5 states

The greatest differences among state corporate tax laws occur in the definition of these factors. Even though states may use the same formulae, they often define the factors differently.

For example, the sales factor is defined in several different ways in the various states. The following table indicates the major definitions in use and their frequency:

1. Identification of the sale by the state in which the sales office principally handling the sale is located
—15 states
2. Identification of the sale by reference to the location of the customer to whom the sale is made—6 states
3. Identification of the sale by reference to the state in which the physical goods were located at the time they were appropriated to orders or shipped to the customer
—5 states

A similar but less significant problem exists with respect to definition of the payrolls factor. The states at present use two basic definitions in this connection:

1. Identification of payrolls by reference to the home

²⁷COUNCIL OF STATE GOVERNMENTS, *op. cit. supra* n. 25, 5-7.

- office or place of business at which the employees principally work —8 states
2. Identification of payrolls by reference to the place where services are actually performed, without regard to the location of the home office —5 states

The problem with respect to the definition of the property factor is less serious. By and large, there is substantial agreement among the states that the property factor should include all of a taxpayer's tangible property that is physically located in the taxing state. In addition a small number of states provide that property rented and used by the taxpayer should be included in the property factor by a procedure that projects a capitalization for the rentals the taxpayer pays.

Following the intent of the 1953 Governors' Conference resolution, the Council of State Governments established an Advisory Committee on State Corporate Income Taxation. After consideration of the existing apportionment situation, the Committee concluded that: (1) uniformity of apportionment formulae is highly desirable; (2) allocation as distinguished from apportionment should be minimized and restricted to income items not related to the major business activities of a given taxpayer; (3) the three-factor formula of sales, payrolls, and tangible property should be uniformly adopted; (4) uniform factor definitions should be adopted. However, the Advisory Committee felt that the fiscal impact of particular factor definitions should be determined prior to agreement upon any recommended definitions.

Accordingly, the Council of State Governments made a survey of the revenue impact of three possible alternative uniform apportionment formulae.²⁸

The three formulae used in this survey are indicated in the note.²⁹ Each of these included sales, property, and payroll factors. The property and payroll factors are identical in each of the three formulae used in the survey. The sales factor, which is the source of greatest controversy, was varied. In formula one (1), the sales factor was based on the place that the sale was negotiated; in formula two (2), on the origin of the goods sold; in formula three (3) on the place of delivery of the goods sold. Questionnaires were prepared asking respondents to compute

²⁸The results of this study are reported in COUNCIL OF STATE GOVERNMENTS: REPORT OF SURVEY OF EFFECTS OF STATE REVENUES OF VARIOUS PROPOSED UNIFORM APPORTIONMENT FORMULAS (May, 1956), which is the basis for this section of this article.

²⁹The formulae used in the survey were as follows:

Formula 1. (Negotiation)

Sales Factor. (Negotiation).

Sales in this state shall include those assignable to offices, agencies or places of business within the state, provided such receipts shall be assigned to that office, agency or place of business at or from which the transactions giving rise thereto are chiefly negotiated.

their actual 1954 corporate income or franchise tax liability and the income or franchise tax liability they would have incurred if each of the three hypothetical apportionment formulae had been in effect.

The Council obtained a list of corporate taxpayers, reporting income for state income or franchise tax purposes on an apportionment basis, from cooperating state tax administrators. Questionnaires were sent to a sample of 650 corporate taxpayers; 125 usable replies were obtained. The 125 responses indicated the following alternative situations:

<i>Basis for computation:</i>	<i>Tax Liability</i>
Actual tax liability (1954)-----	\$33,595,206
Formula 1 (negotiation)-----	34,666,895
Formula 2 (origin)-----	34,536,313
Formula 3 (delivery)-----	32,395,160

Thus, if formula 1 (negotiation) had been in effect, the 125 respondents as a group would have paid additional taxes of \$1,071,689. If formula 2 (origin) had been operative, they would have had an increased tax liability of \$941,107. On the other hand, under formula 3 (delivery), their tax bill would have been decreased by \$1,200,046.

The findings of the Council of State Governments survey were summarized in its final report as follows:³⁰

Payrolls Factor.

Payrolls in this state shall include all compensation for services actually performed within this state regardless of the location of the office from which employees conduct operations.

Property Factor.

Property in this state includes all tangible property, real, personal and mixed, owned or used by the taxpayer in this state in connection with the trade or business done by the taxpayer in this state during the taxable period. The value of the corporation's tangible property for the purpose of this section shall be the original, undepreciated cost of such property averaged at the beginning and end of the taxable period; except that, in the case of inventories, the averaged monthly inventories at book value of all products held for sale, lease or other distribution shall be used, and rental property shall be valued by multiplying by eight (8) the annual consideration for the use of such property.

Formula 2. (Origin)

Sales Factor. (Origin).

Sales in this state shall include those made from warehouses, stores or inventories located within this state regardless of the location of the purchaser and regardless of the location of the office, branch office, agent or agencies through which such sales are made.

The definitions of the payrolls and property factors are identical with those in Formula 1 above.

Formula 3. (Delivery).

Sales Factor. (Delivery).

Sales within this state shall include all sales of tangible personal property to purchasers within this state.

The definitions of the payrolls and property factors are identical with those in Formula 1 above.

³⁰ *op. cit. supra*. n. 28.

Formula 1 would:

- a. Result in the largest total tax payments by concerns in the survey;
- b. Produce increased tax payments by concerns in the survey in fifteen states;
- c. Result in the largest tax payments as compared with payments under other formulas or present law in five states;
- d. Result in the smallest tax payments as compared with other formulas or present law in fifteen states;
- e. Increase tax payments for concerns in the survey by more than 10 percent in eight states;
- f. Decrease tax payments for concerns in the survey by more than 10 percent in ten states.

Formula 2 would:

- a. Result in larger total tax payments for concerns in the survey than under present law, but not as large as those under formula 1;
- b. Produce increased tax payments by concerns in the survey in twenty-five states;
- c. Result in the largest tax payments by concerns in the survey in fourteen states;
- d. Result in the smallest tax payments by concerns in the survey in four states;
- e. Increase tax payments for concerns in the survey by more than 10 percent in fifteen states;
- f. Decrease tax payments for concerns in the survey by more than 10 percent in five states.

Formula 3 would:

- a. Result in the smallest total tax payments by concerns in the survey;
- b. Produce increased tax payments by concerns in the survey in twenty-one states;
- c. Result in the largest tax payments by concerns in the survey in nine states;
- d. Result in the smallest tax payments by concerns in the survey in three states;
- e. Increase tax payments for concerns in the survey by more than 10 percent in ten states;
- f. Decrease tax payments for concerns in the survey by more than ten percent in six states.

Present laws:

- a. Result in smaller total tax payments by concerns in the survey than would formulas 1 or 2, but larger payments than would formula 3;
- b. Result in larger tax payments by the concerns in the survey than any of the three formulas in seven states;
- c. Result in smaller tax payments by concerns in the survey than any of the proposed formulas in thirteen states.

The Council concluded its report with observations that: (1) the states in general would not gain or lose significant amounts of revenue if they were to adopt formula uniformity; (2) a few states would have significant revenue gains and few might have serious revenue losses; (3) each of the three formulae would produce about the same total revenue for the states as a group; (4) a tripartite sales factor including negotiation, delivery and origin might be most equitable and limit the effect of formula changes on present state tax revenue. Comment on this last suggestion will be reserved until later.

In making this study, the Council of State Governments struck out into what has been a virtually unknown area in state taxation. While the problems have been apparent for many years, there has been virtually no empirical investigation of the fiscal impact of alternative apportionment formulae. This survey has made a very valuable first step in the direction of providing more factual knowledge on the subject. While, as the survey indicates, the total revenue available to the thirty-five levying states and territories as a group would not be materially affected by the adoption of any one of the three formulae used as a basis for the survey, the individual fiscal impact of such adoption would be quite variable. This fact stands squarely in the way of easy adoption of formula uniformity, as it has in the past. For example, adoption of formula 1 would cause an increase in corporate income tax revenue in Iowa from payments by firms reporting in the survey of about 146% (from \$23,482 to \$57,740); conversely, such adoption would cause a decrease of approximately 43% in similar revenues accruing to the District of Columbia.³¹ (from \$59,111 to \$33,615). While these are extreme examples and while the revenue effects are not so large in a dollar sense, the diversity of impact from adoption of any given apportionment formula raises substantial questions about the price that state policymakers will be willing to pay for uniformity. Nevertheless, the basic fact remains that for many jurisdictions the price that would have to be paid in revenue foregone for apportionment uniformity is not necessarily prohibitive. Even so, in these days of urgent demands on the public purse from all quarters, policymakers can reasonably be expected to seek additional fiscal data before embracing uniformity too readily.

In a report circulated at the 1956 Governors' Conference, the Council of State Governments suggested that further research by individual states is required and that a uniform state law is needed.³² What attention, if any, the several states will give to the wise suggestion for further research on the fiscal impact of alternative apportionment formulae remains to be seen. One prime difficulty appears to be that uncoordinated research carried on by various state agencies produces

³¹ *Ibid*, Table 4.

³² COUNCIL OF STATE GOVERNMENTS: STATE CORPORATE INCOME TAXATION OF MULTI-STATE BUSINESS, 1956, 3-4.

results that are difficult to use for comparative purposes such as the development of uniform legislation.³³ The Council's second suggestion—that uniform legislation is needed—is timely. The drafting of proposed uniform legislation on allocation and apportionment of income for state tax purposes is already well advanced; such proposed legislation will be considered in the next section of this paper.

PROPOSED UNIFORM STATE LAW

While, as the previous discussion indicates, substantial progress has been made, basic data on and analysis of the income allocation and apportionment problem are incomplete. Even so, policy formation seldom can wait until all facts are known and ideal analysis is complete. As a matter of practical realism, all of the facts will never be available; the scene is constantly changing. Accordingly, development of a uniform state law dealing with the apportionment problem is an appropriate and timely step if present diversity in this tax area is to be mitigated by cooperative state action. While many have waxed cynical about prospects for such cooperation, other avenues to a solution seem even more unlikely. Development of uniform legislation is a necessary first step along one road to a solution of the problem.

A Committee of the National Conference of Commissioners on Uniform State Laws has under consideration a draft "Uniform Allocation and Apportionment of Income Act."³⁴ This proposed legislation was considered by the Conference at its 1956 meeting in Dallas.³⁵ In accordance with the usual practice of the Commissioners, the draft act was referred back to the originating Committee for further study, reconsideration, and possible resubmission to the Conference at its 1957 meeting. The preliminary draft act used for working purposes at the 1956 NCCUSL meeting will be considered here.³⁶ It should be emphasized that the Conference has not adopted a Uniform Allocation and Apportionment of Income Act; it may never do so. If it does do so at some future time there is no present assurance that such legislation would follow the form of the draft here discussed. However, this draft represented the consensus of the NCCUSL Committee as of August, 1956. It merits consideration and general discussion even though its final form may be modified.

³³ Report of the Subcommittee on Coordination of Research, Committee on State and Local Taxes, Section of Taxation, American Bar Association, 1956.

³⁴ See, 20 TAX ADMINISTRATORS NEWS 138 (Dec., 1956).

³⁵ See *National Conference of Commissioners on Uniform State Laws*, 42 A.B.A.J. 1040 (Nov., 1956).

³⁶ Quotation from and reproduction of the preliminary draft of the Uniform Allocation and Apportionment of Income Act is made with the permission of Mr. George V. Powell, Esq., of the Washington Bar, Chairman of the Committee of the National Conference of Commissioners on Uniform State Laws which prepared the draft act. This permission is gratefully acknowledged and much appreciated by the writer.

The August, 1956 version of the tentative draft Uniform Allocation and Apportionment of Income Act contains twenty-two sections. It is reproduced in full in the Appendix to this article. Section 1 provides basic definitions. Section 2 requires a taxpayer doing business both within and without the taxing state to allocate and apportion its income under the act. Section 3 defines "taxable in another state" as the situation where, in that state, taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or where taxpayer would be taxable in that state if such state adopted the tax law of the levying state. Section 4 provides for the allocation of non-business income. Sections 5-9 provide allocation rules for such income. Sections 10-18 provide an apportionment method for unallocated income. Section 19 authorizes the tax administrator, in his discretion, to require separate accounting or to prescribe alternative formulae where appropriate and acceptable to the taxpayer. Section 20 notes the legislative intent that the act be construed so as to effectuate uniformity objectives. Section 21 contains the title. At this point, the reader may wish to refer to the draft act in the Appendix.

Only the main provisions of the act will be commented on here. In connection with the writer's comments, it should be noted that the National Committee on State and Local Taxation of the Controllers Institute of America has studied the draft act at some length; the comments of that group will be indicated.³⁷ Their reaction provides an additional basis for appraisal of the draft act. The general criticisms contained in the Controllers Institute Committee letter are relevant at this point. These comments were submitted as constructive criticism with a quite evident awareness of the many problems that arise in developing uniform legislation; they are indicated, in part, below:

Principal shortcomings [of the act] are:³⁸

(1) There has been introduced a new concept for the allocation of specific items of non-business income in addition to the bases now generally recognized of assignment on the basis of physical situs of property from which the income is derived if it is tangible property and, if the income stems from intangible property, on the basis of either an acquired business situs or the domicile of the taxpayer if no business situs has been acquired. This new concept as stated in Section 1 (c) of the Act would use as an additional factor the principal place of business which is defined to mean that state to which the

³⁷ The writer gratefully acknowledges the kindness of Mr. Paul A. Reck, Chairman, National Committee on State and Local Taxes, Controllers Institute of America in authorizing quotation from the letter of that committee to Mr. George V. Powell, Esq., Chairman of the NCCUSL Committee, dated August 9, 1956. This letter will be referred to herein as the Controllers Institute Committee letter.

³⁸ The phrase "principal place of business", referred to in this quotation was replaced with "principal income state" in the draft of the act under consideration here.

greatest percentage of income is or would be apportioned under the physical apportionment formula. This method is very unsatisfactory and is subject to fluctuation from period to period.

(2) The Act includes methods for identification and allocation of specific items of non-business income and thereby introduces a number of indeterminate obstacles in attaining a uniform apportionment formula which are difficult to evaluate. Since their inclusion will greatly compound the problems in the adoption of a uniform apportionment formula it is believed that the sections of the Act pertaining to the allocation of non-business income might more appropriately be made the subject of another Act to be kept separate from that proposed for the apportionment of income. Thus a clear distinction between allocation of income and apportionment of income could be best accomplished. In general, our committee is disinclined to take exception to the manner in which allocations are being made in the majority of those states where non-business income is now being allocated. (See Exhibit 1 of Controllershship Foundation Report of April 1954).

(3) A number of catchall provisions have been inserted into the Act which are highly objectionable from the standpoint of taxpayer and which are contrary to the principles stated above. These catchall provisions have the expressed intent of taxing the full sales of a company in one state or another, and if they terminate into a state where the company is not doing business, then they are arbitrarily added back to the apportionment factor of the shipping state where the company is doing business. Such provisions are contrary to the basic principle that a state is only entitled to use, as a measure of its tax, the activities attributable to it and *only* when the company is doing business in that state in the first place.

(4) There are a number of ambiguities existent in the language throughout the Act which require extreme care in their clarification. A further amplification of the definitions would also be helpful in clarifying much of the language.

The provisions of the draft act and the above comments thereon suggest basic differences of opinion that are difficult to reconcile. Certainly, in some cases, the "principal income state" would vary from period to period. *Quaere*, would this provide in adequate degree the elements of certainty and predictability that are always important in taxation? More significant perhaps is the question raised as to whether both allocation and apportionment should be covered in the same uniform act. It is natural to desire a complete solution to the problem at hand in a proposed uniform state law. On the other hand, unless a proposed law can be adopted it will be of little aid to taxpayers subject to existing diversity and resultant compliance costs. This writer would agree with the Controllers Institute Committee that the NCCUSL committee might appropriately consider leaving allocation problems to

one side for the time being and limiting the proposed uniform act to the apportionment of income.

Paragraph (3) of the Controllars Institute Committee letter deals with the sales factor in the apportionment formula. The definition of the sales factor is perhaps the most controversial element in any apportionment formula, be it actual or proposed. The definition in Sections 10-18 of the draft act provides no exception to this generalization. The NCCUSL draft (Sections 16, 17) assigns sales to the state of destination except where the purchaser is the United States government *or* when the taxpayer is not doing business in the state of destination. In this latter case, the sales are assigned back to the state of origin. Thus, if the uniform law were in effect in all levying states, all sales would be included in the numerator of the sales factor of the apportionment factor of one state or another. Evaluation of this suggested shifting assignment of sales is a thorny problem.

Ordinarily, in apportionment formulae, the property and payroll factors tend to favor the state of origin or production in the assignment of income. The basic theory justifying the inclusion of the sales factor in such formulae is that it offsets the effects of the property and payroll factors and protects the interest of the state of destination. This seems appropriate since the state of delivery clearly contributes to the income arising from the sale; it has provided the market. Accordingly, many would assign sales to the state of delivery—at least in terms of apportionment theory. Such theory doesn't go far in reconciling basic clashes in economic interest or in palliating the impact of potential revenue loss.

The NCCUSL draft sales apportionment proposal is logical in that it assigns sales to the buyer's state when the corporate taxpayer is doing business there. However, when this is not the case so that there would be no tax consequence in the buyer's state, sales are shifted back to the state of origin. Logical though this may be, it is the type of provision that produces understandable taxpayer irritation. It also would seem to pose administrative and compliance problems. It will be recalled that compliance costs attributed to the present tax pattern constitute one reason for the desire for formula uniformity in the first place.

It was noted earlier that the Council of State Governments suggested a tripartite sales factor—origin, destination, and negotiation—as being both equitable and having the least impact on the existing distribution of state tax revenues. At least one state tax administrator has already classified this proposal as equitable but one that would complicate both compliance and administration.³⁹ Potential compliance and administrative cost levels must be given consideration in evaluation of sales factor definition proposals.

³⁹Holt, *Interstate Allocation of Corporate Income*, PROC. NAT'L. TAX ASS'N., 1956 (Forthcoming).

The Controllers Institute Committee letter makes another proposal for a sales factor definition as follows:⁴⁰

Gross Receipts Ratio: The ratio of gross receipts from sources within this State and business activities engaged within this State to total gross receipts from sources and business activities engaged in everywhere. For the purpose of this section, receipts shall be deemed to have been derived from sources and business activities within this State by taking the sums of (1) fifty (50) per cent of receipts from products shipped to customers in this State from points outside this State, and (2) fifty (50) per cent of receipts from products shipped to customers outside this State from points within this State, and (3) one hundred (100) per cent of receipts from products shipped to customers within this State from points within this State, or physically delivered to customers or their agents within this State, regardless of the disposition thereafter made of such products or the location of the place of business of the customer.

This proposed factor definition ignores solicitation and selling activity; it compromises fifty-fifty between the assignment of sales to the state of origin and the state of destination. Such a proposal for a realistic compromise between the conflicting interests involved appears to have much to commend it; if it would speed adoption of a uniform rule some lack of elegance easily could be forgiven. Taxation is an eminently practical matter and apportionment is at best a rough and ready solution to a difficult and intractable problem. If the compromise proposal noted above can reconcile basic economic conflicts, it would seem, at least to this commentator, well worthy of consideration.

Numerous other comments and questions can be raised about the draft act. Should rents be capitalized in the property factor? How should compensation be defined and restricted in the payroll factor, and so on? However, the definition of the sales factor is far more controversial than these questions.

Legislatures have a natural reluctance to shift from accustomed tax patterns for the sake of a general goal like uniformity. This is particularly true when a revenue loss is or may be implicit in the action. Accordingly, compromise between the conflicting interests involved is required to achieve uniformity. This fact, as well as the substantive merits of alternative proposals, must be considered. The NCCUSL Committee, the Council of State Governments, and the Controllers Institute Committee are to be congratulated on the progress made in the last three years. However, unless acceptable compromises can be made, the phrase in the title of this article—*natura non facit saltum*—will

⁴⁰ Controllers Institute Committee letter, dated August 9, 1956, p. 6. The letter included certain qualifying and explanatory material which is not quoted in full here in view of space limitations. In the opinion of the writer, the essentials of the proposal are contained in the suggested factor definition.

continue to describe the apportionment situation as it has in the past. It is to be hoped that this is not the case. Somehow the Gordian knot needs to be severed and a reasonable degree of uniformity attained in the apportionment formulae used by the several states taxing income of corporations doing a multistate business. Many persons will be interested in what modifications, if any, are made in the NCCUSL draft act. They will be even more concerned about its future potentialities. Unless substantial progress can be made in dealing with problems of this type, the centripetal drift of fiscal power in our federal system will continue.

APPENDIX
Preliminary NCCUSL Committee Draft
of a
Uniform Allocation and Apportionment
of Income Act

SECTION 1. As used in this Act, unless the context otherwise requires:

(a) "Compensation" means wages, salaries, commissions and any other form of remuneration for personal services.

(b) "Financial organization" means any bank, trust company, savings bank, [industrial bank, land bank, safe deposit company] private banker, savings and loan association, credit union, [cooperative bank], investment company, or any type of insurance company.

(c) "Principal income state" means the state to which the greatest percentage of income is or would be apportioned under the basic apportionment formula set forth in sections 10 through 18 of this Act.

(d) "Public utility" means [any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products, or gas.]

Note: Each state may wish to enact separate legislation to apportion and allocate the income of taxpayers subject to the control of its regulatory bodies.

(e) "Sales" means all income of the taxpayer not allocated under section 4 through 9 of this Act.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

SECTION 2. Any taxpayer deriving income from business activity carried on both within and without this state [other than activity as a financial organization or public utility or the rendering of purely personal services by an individual] shall allocate and apportion his net income as provided in this Act.

SECTION 3. For purposes of allocation and apportionment of income under this Act, a taxpayer is taxable in another state if (1) in that state he is subject to a net income tax, a franchise tax measured by net income or a franchise tax for the privilege of doing business or (2) he would be required to pay a [net income tax] in that state if that state adopted the [net income tax] law of this state.

SECTION 4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties shall be allocated as provided in sections 5 through 9 of this Act.

SECTION 5. (a) Rents and royalties from real or immovable tangible personal property located in this state are allocable to this state.

(b) Rent and royalties from movable tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if this state is the taxpayers' principal income state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of movable tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, movable tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

SECTION 6. (a) Capital gains from sales of real and immovable tangible personal property located in this state are allocable to this state.

(b) Capital gains from sales of movable tangible personal property are allocable to this state if

(1) the property was located in this state at the time the purchaser took title to the property, or

(2) this state is the taxpayer's principal income state and the taxpayer is not organized under the laws of or taxable in the state in which the property was located at the time the purchaser took title to the property.

(c) Capital gains from sales of intangible personal property are allocated on the same basis as if the issuer of the intangible personal property were the payer of interest.

SECTION 7. Interest and dividends are allocable to this state if:

(a) The interest and dividends originate in this state, or

(b) This state is the taxpayer's principal income state and (1) the taxpayer is not organized under the laws of or doing business in the state in which the interest and dividends originate, or (2) the interest and dividends do not originate in any state under section 8 of this Act.

SECTION 8. Interest and dividends originate in a state if:

- (a) The payer is an individual who is a resident of the state; or
- (b) The payer is the state or a political subdivision thereof; or
- (c) The state is the payer's principal income state.

SECTION 9.(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized in this state, or

(2) in their entirety if this state is the taxpayer's principal income state and the taxpayer is not organized under the laws of or taxable in the state in which the patent or copyright is utilized.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state which is the taxpayer's principal income state.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state which is the taxpayer's principal income state.

SECTION 10. All income not allocated under sections 4 through 9 of this Act shall be apportioned to this state by multiplying the income by the percentage derived by use of the following formula:

Property Factor plus Payroll Factor plus Sales Factor.

SECTION 11. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented during the tax period.

SECTION 12. Property owned by the taxpayer is valued at its original cost less any depreciation or depletion permitted under the [tax law] of this state. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from sub-rentals.

SECTION 13. The average value of property shall be determined by averaging the values at the beginning and ending of the tax

period but the [tax administrator] may require the averaging of monthly values during the tax period.

SECTION 14. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

SECTION 15. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state; or
(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) some of the service is performed in this state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in this state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

SECTION 16. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

SECTION 17. Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not organized under the laws of or taxable in the state of the purchaser.

SECTION 18. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or

(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

SECTION 19. If the allocation and apportionment provisions of this Act do not relate to the class of business in which the taxpayer is engaged or do not fairly represent the extent of the taxpayer's business activity, in this state, the [tax administrator], in his discretion, may require separate accounting, or may prescribe an appropriate method of allocation and apportionment acceptable to the taxpayer.

SECTION 20. This Act shall be so construed as to effectuate

its general purpose to make uniform the law of those states which enact it.

SECTION 21. This Act may be cited as the Uniform Allocation and Apportionment of Income Act.

SECTION 22. [The following acts and parts of acts are hereby repealed:

(a)

(b)

(c)

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SECTION 23. This act shall take effect _____